

FSOC Issues Final Rule on Designation of Systemically Important Nonbank Financial Companies

Yesterday, the Financial Stability Oversight Council issued its final rule and interpretive guidance setting forth the process by which it will designate a nonbank financial company as systemically important under the Dodd-Frank Act. Although the final rule contains some noteworthy modifications and clarifications, it adopts without substantial change the proposal from October 2011, including the three-stage designation process and the quantitative screening criteria for the Stage I analysis.

The Council also issued its final rule to implement provisions of the Freedom of Information Act, which sets forth procedures for requesting access to, and making disclosures of, information contained in Council records. The Council's FOIA rule (which is [available here](#)) states that unless precluded by law, the Council may make discretionary disclosures after weighing the particular facts and circumstances of each request. The FOIA rule also provides that the Council may not reject a FOIA request solely because the request contains one or more technical deficiencies.

In addition, on April 2, the Federal Reserve Board issued a proposed rule relating to the definition of a company that is "predominantly engaged in financial activities" that may be designated as systemically important. A separate DavisPolk Client Memorandum will cover this proposed rule, which broadens the universe of potentially covered companies.

The discussion below assumes familiarity with the October 2011 proposal on designation of systemically important nonbank financial companies (a summary of which is [available here](#)) and highlights the changes in the final rule. The final rule will be effective 30 days after publication in the Federal Register, but as noted in our prior memorandum, the Council need not wait until the rule is effective to start evaluating companies and may begin issuing determination notices to high priority targets shortly after the effective date.

Highlights of Changes in the Final Rule

- **Stage I Factors.** In Stage I, the Council will use a set of uniform, quantitative metrics to identify nonbank financial companies that will be subjected to the more qualitative, company-specific evaluations in Stages II and III. The Council declined to tailor the Stage I factors by industry to provide a more accurate indication of the threat an entity would pose to U.S. financial stability. Some noteworthy changes to the Stage I factors include:
 - **New "total debt outstanding" factor:** To advance beyond the Stage I analysis, a nonbank financial company would need to satisfy the "total consolidated assets size" threshold of \$50 billion or more **and**, in addition, one of six factors. The proposed guidance had included as one of these six factors a "loans and bonds outstanding" threshold of \$20 billion or more. The final interpretive guidance changes this factor to \$20 billion or more of "total debt outstanding." The Council states that it will define the term "total debt outstanding" broadly, and regardless of maturity, to include loans (whether secured or unsecured), bonds, repurchase agreements, commercial paper, securities lending arrangements, surplus notes (for insurance companies) and other forms of indebtedness. The interpretive guidance has also been revised to state that this definition of "total debt outstanding" will be used in calculating another of the six factors, the "short-term debt ratio" threshold, which is satisfied if a nonbank financial company has a short-term debt to total assets ratio of 10 percent or more.

- Foreign nonbank financial company and its subsidiaries. The final interpretive guidance clarifies that for purposes of evaluating any foreign nonbank financial company, the Council will calculate the Stage I thresholds based solely on the U.S. assets, liabilities and operations of the foreign nonbank financial company and its subsidiaries.
- Treatment of certain funds. The final interpretive guidance states that for the purposes of applying the quantitative thresholds to investment funds (including private equity firms and hedge funds), the Council may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar. Similar language was in the proposal, which stated that for the purposes of applying the Stage I factors to investment funds managed by a nonbank financial company, the Council may consider the funds "as a single entity" if their investments are identical or highly similar.
- Review every five years. The Council will review the appropriateness of the levels of the Stage I thresholds that are specified in dollars at least once every five years. The Council will not automatically adjust the Stage I threshold levels based on indexes such as inflation or economic growth.
- Most recently available quarterly data. The Council will apply the Stage I thresholds to nonbank financial companies using the most recently available data on a quarterly basis (or less frequently for nonbank financial companies with respect to which quarterly data are unavailable). The Council declined to base the calculations on multi-period averages, which commentators had argued would reduce volatility and mitigate the effects of any unusual or one-time items.
- GAAP v. other accounting principles. The Council will generally apply the Stage I thresholds using GAAP when such information is available. If GAAP information with respect to a nonbank financial company is not available, the Council may rely on data reported under statutory accounting principles, international financial reporting standards, or such other data that is available to the Council.
- **Stage II Review.** As part of the Stage II review, the Council will consult with the primary financial regulatory agency, if any, of each significant subsidiary of the nonbank financial company, to the extent the Council deems appropriate.
- **Credit Default Swaps and Interconnected Analysis.** In reviewing the amount of gross notional credit default swaps outstanding to conduct its Stage II "interconnectedness" analysis, the Council will consider not only CDS for which the nonbank financial company is the reference entity but also CDS for which its parent is the reference entity.
- **Consideration of Firm's Resolvability in Stage III.** The interpretive guidance has been modified to state that a firm's resolvability may mitigate, or aggravate, the potential of a nonbank financial company to pose a threat to U.S. financial stability.
- **When Firm Notified; When Public Notified.** The Council will not notify a company that it is under review for designation as systemically important until after the Stage II review has been completed and the company is contacted about the Stage III review. The final rule clarifies that any evidentiary hearing in which a company seeks to contest a proposed determination by the Council will be conducted in a nonpublic forum. The Council will not announce the name of any nonbank financial company that is under evaluation for a determination prior to a final determination. Once a determination has been made that a company is systemically important, the Council will endeavor to provide that company with at least one business day's prior notice before publicly announcing the designation.

▪ **Other Significant Modifications and Clarifications.**

- Broad interpretation of the term “company”. The Council will interpret the term “company” broadly with respect to nonbank financial companies to include any corporation, limited liability company, partnership, business trust, association or similar organization, but generally not to include unincorporated associations. This language narrows the scope of the term “company” in the proposal, which had explicitly included unincorporated associations.
- Confidentiality. The final rule clarifies that the confidentiality protections under the rule will apply to data, information and reports that are voluntarily submitted by any nonbank financial company being considered for determination. The final rule states that the Council may, to the extent the Council determines appropriate, accept the submission of any data, information and reports voluntarily submitted by a company that is the subject of a Council determination.
- Not less than 30 Days to submit written materials to Council. A nonbank financial company that has been notified by the Council of a proposed determination must be given at least 30 days after the date of receipt of the notice to submit a written response.
- Notice of reevaluation. If the Council decides to change the status of a company subject to a currently effective determination that it is systemically important, it must provide written notice to that company prior to the Council’s reevaluation of that determination and must provide the company with at least 30 days from when it receives the Council’s notice to submit written materials contesting the reevaluation determination.
- Notice of rescission. If the Council rescinds a determination that a nonbank financial company is systemically important, the Council must notify that company in writing and publicly announce the rescission.

The final rule leaves unchanged the Council’s position that in certain limited cases, it may include a nonbank financial company in its Stage II pool even if the company does not meet the thresholds set forth for the Stage I analysis. Thus, the Council retains significant discretion regarding whom it will subject to further review. As in the proposal, the final interpretive guidance acknowledges that the quantitative Stage I measures may not be appropriate for hedge funds and private equity firms and states that the Council intends to rely on the information and data disclosed to the SEC on the new Form PF to determine whether to establish additional Stage I factors applicable to hedge funds, private equity firms and their advisors. The Council states that it may develop additional guidance regarding thresholds applicable to asset managers at a later date, potentially including factors related to assets under management.

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